MEMORANDUM

TO: Members of Market Mechanism Study Group

FROM: Anthony Dolanski

DATE: March 30, 2000

RE: Suggestions for Market Models

This memorandum is in follow-up to the discussion that began at the first meeting of the market mechanism study group. At end of that meeting, many offered options for market models for the group to consider. I suggested two models: the Federal Housing Administration's (FHA) single family mortgage insurance program and the alternative student loan (private credit) market, which I termed classic competition. I have attached brief descriptions of both.

I believe that the purpose of the study group is to craft market-based models for determining interest rates on guaranteed student loans. The presentations during our initial meeting were constructive in launching the study and stimulating ideas. I would like to suggest that we take a more expansive view of our task to ensure that our work is comprehensive and credible. For example, we should address the interests of the affected parties: borrowers, schools, taxpayers and the government, lenders, guarantors, states and direct lending. Similar to the first study, it would be useful to establish a set of principles; affordable and accessible credit for all eligible students; schools as gatekeepers; simplification of the guarantee process; performance-based servicing standards; school choice; vigorous competition; continuous investment in technology and infrastructure; long-term stability so that funding is assured through all economic and political cycles; and clear consumer disclosure. There are probably others. I also find it helpful to isolate the issue of subsidies. Under a market-based system all subsidies are directed to students, not providers.

The FHA model is relevant in that it is a federal program that had a regulated rate that was changed to a market-determined rate. The alternative student loan model should be considered as it truly uses the market in determining the rates for those loans. This market has grown considerably in the last few years, as most major lenders now offer non-federal supplemental loans to undergraduate and graduate students. The lender sets rates for these loans based on borrower credit criteria as well as school profiles, with the schools acting as agents of the student borrowers. Both of these models are important to consider because they allow the borrower or the school as agent to act as the consumer and to consider factors such as price as well as service in determining the appropriate lender.

Attachments

Federal Housing Administration's
Single Family Mortgage Insurance Program

In an effort to transform the rate-setting process in the current student loan program to a more market-driven form, it has been suggested that the guaranteed student loan program could adapt the regulatory model used by the Federal Housing Administration's (FHA) single family mortgage insurance program. The FHA program is a real world example of a government-guaranteed loan program that has successfully moved from an administratively set rate negotiated between the lender and the borrower. This transition was completed with little disruption to the program or to the borrowers whose rates are comparable to the conventional mortgage market.

The FHA program provides federal insurance on mortgage loans originated by a network of FHA-approved lenders. Lenders originate loans pursuant to the FHA's loan size, property and credit criteria. While FHA does not set program interest rates, there are regulations limiting price variability within an individual lender's portfolio. In addition, the FHA places limits on the amount of borrower fees.

Several features of the FHA model could serve as a useful template for redesigning the Federal Family Education Loan Program (FFELP):

<u>Market-Based Rate Transition</u>: Prior to 1984, the Secretary of Housing and Urban Development (HUD) set the maximum rate for the FHA single family program. In 1984, legislation was passed that required the rate to be negotiated between the lender and the borrower. Experience shows a convergence of FHA and conventional rates since 1984 and that interest rate deregulation did not cause any adverse side effects.

<u>Tiered Pricing Rule:</u> Although FHA no longer sets the rate, there are regulations that prohibit excess variation in lenders' pricing practices. The "tiered pricing" rule restricts variations in "mortgage charge rates" (which includes interest, points and origination fees) to two percentage points for loans of the same type, closed on the same day, in the same geographic area. Moreover, variations within the two percentage point spread must be explained by actual variations in a lender's costs. Lenders are required to maintain a record of their pricing activities, and documentation of any variations within the two-point band. FHA's "tiered pricing" provides useful guidance in gauging the level of variability in FFELP

interest rates that would be needed under a market-based approach to account for differences in school default rates and average borrowing levels.

Broader Consumer Choice: Moving away from a one-size-fits-all product, the FHA program now offers borrowers a wide array of product options such as different down payments and payment periods, different options on rates and fees, bi-weekly vs. monthly payments, payroll deduction options, ARM vs. fixed rates. The emergence of these options produced market competition which in turn generated better loan attributes for consumers.

Alternative Loan Programs—"Classic Competition"

The past few years have seen a growth in the market for alternative student loans. Alternative private loans are non-federal loans that are generally offered to borrowers through schools as part of a package of loan services, including FFELP loans. Most major lenders offer some type of alternative student loan package. These loans are designed to meet the gap between available financial aid and the cost of attending college—often serving as an alternative to credit card borrowing or home equity loans. These loans are generally less expensive than credit card borrowing and do not tie up the equity of homes.

<u>Rate-setting mechanism:</u> The rates are set in this program by the lender and offered to schools as a part of the lender's package of student loan services. These rates are determined by the market for these loans—schools act as agents, similar to FFELP, and provide a list of recommended alternative loan programs to student borrowers.

The rates vary by school type and among lenders. There are great variations in eligibility requirements. Some lenders determine pricing and eligibility on the creditworthiness of borrower or co-borrower. Because these loans are not federally guaranteed, many lenders consider credit history in pricing and can require a co-borrower. Some lenders determine pricing and eligibility by school type and school default history.

Most of the rates on these loans are variable, adjusting quarterly, often using the Prime Rate as an index.

<u>Considerations:</u> The alternative loan market should provide several useful lessons in how a market mechanism would work in setting student loan rates. These rates are truly market based. However, unlike the federal guaranteed program, these loans are not universally available. There are some schools, because of their general default risk, that do not have access to the traditional private credit loan programs.